



November 2014

DEFENSE CONTRACT AUDIT AGENCY

Additional Guidance Needed Regarding DCAA's Use of Companies' Internal Audit Reports

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Highlights of GAO-15-44, a report to Congressional Committees

November 2014

DEFENSE CONTRACT AUDIT AGENCY

Additional Guidance Needed Regarding DCAA's Use of Companies' Internal Audit Reports

Why GAO Did This Study

DCAA audits play a critical role in oversight of companies that provide goods and services to the Department of Defense. These defense companies also conduct their own internal audits. Section 832 of the NDAA for Fiscal Year 2013 (Pub. L. No.112-239) required DCAA, among other things, to revise its audit guidance on documenting its requests for defense contractors' internal audit reports and ensuring the reports are used only for evaluating and testing the strength of internal audit controls.

The act required GAO to assess the revised guidance. This report assesses the extent to which DCAA's revised guidance (1) complied with the act, and whether selected requests for company internal audit reports were documented in accordance with requirements, and (2) contains safeguards to help ensure that companies' internal audit reports are used only for authorized purposes. GAO compared DCAA's revised guidance to the provisions of the act and examined a nongeneralizable, random sample of eight recent DCAA requests for companies' internal audits.

What GAO Recommends

GAO recommends that DCAA clarify its guidance and establish and monitor internal controls to help ensure that requests for company internal audits are fully documented in accordance with the act, and that the guidance defines authorized use. DCAA concurred with GAO's recommendations.

View [GAO-15-44](#). For more information, contact William T. Woods at (202) 512-4841 or woodsw@gao.gov.

What GAO Found

The Defense Contract Audit Agency (DCAA) revised its guidance in the Contract Audit Manual to address the documentation requirements mandated by section 832 of the National Defense Authorization Act (NDAA) for Fiscal Year 2013, but implementation has been inconsistent. The revisions include provisions for DCAA auditors to document (1) that access to company internal audit reports is necessary to an ongoing DCAA audit, (2) the request sent to the company, and (3) the company's response. However, based on GAO's review of selected cases, implementing the changes has been inconsistent across the agency. GAO randomly selected eight requests for companies' internal audits and compared them to the mandated requirements and DCAA instructions provided to its auditors as criteria to test whether or not the three documentation requirements had been properly recorded. None of eight cases sampled had complete records for the three required documents. The figure below shows the results of GAO's examination of the eight requests.

Required Documentation for Eight Randomly Selected DCAA Requests to Companies for Internal Audit Reports

Internal audit	A	B	C	D	E	F	G	H
Recorded connection to DCAA audit								
Request to company for internal report								
Company's response included								

Documented Partially documented Not documented

Source: GAO analysis of DCAA data. | GAO-15-44

DCAA's revised guidance is specific about physical safeguards for companies' internal audit information. For example, the Contract Audit Manual contains extensive guidance for physically securing proprietary information and specifies that the working papers should not include a copy of the companies' internal audit reports. However, the guidance is less specific about safeguards to prevent unauthorized use of internal audit reports; that is, using the reports for purposes other than evaluating the efficacy of internal controls or the reliability of the business systems. In particular, the guidance does not define authorized use, provide examples of authorized use, or identify a specific approach for implementing safeguards. Officials stated that plans for an electronic storage system for safeguarding companies' internal audits from unauthorized use are in process as well as guidance for using them. The planned electronic storage capability would provide limited access rights to companies' internal audit reports and thus help ensure better tracking and limit the potential for unauthorized use.

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Abbreviations

DCAA	Defense Contract Audit Agency
GAGAS	Generally Accepted Government Auditing Standards
NDAA	National Defense Authorization Act

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U.S. GOVERNMENT ACCOUNTABILITY OFFICE

441 G St. N.W.
Washington, DC 20548

November 12, 2014

Congressional Committees

The Defense Contract Audit Agency (DCAA) has a critical role in oversight of companies that provide billions of dollars of goods and services to the federal government. This oversight role includes assessing the companies' overall internal controls as well as those controls that address specific business systems such as the accounting, estimating, and purchasing systems. Major defense companies also maintain their own internal audit departments to monitor policies and procedures established by management for the efficient operation of the company and to ensure the integrity of their business systems, including those essential to executing their government contracts. These defense companies' internal audit organizations develop important information about the conduct of business operations and internal controls in support of government contracts as one part of assessing the overall control environment. Information contained in internal audit reports can assist DCAA in setting appropriate audit risk levels which, in turn, can help DCAA auditors determine the appropriate amount of testing they will have to undertake.

Section 832 of the National Defense Authorization Act (NDAA) for Fiscal Year 2013 required DCAA to revise its audit guidance on documenting requests for contractors' internal audit reports and on safeguarding the audit reports against unauthorized use.¹ The act also required us to evaluate the revised guidance. We assessed (1) the extent to which DCAA's revised guidance complied with the act and whether selected requests for company internal audit reports were documented in accordance with the requirements, and (2) the extent to which DCAA's revised guidance contains safeguards to help ensure that internal audit reports obtained from companies are used only for authorized purposes.

To address our objectives, we compared the provisions of the act to DCAA's revised audit guidance regarding documentation and safeguards. We also obtained DCAA documents containing requests for companies'

¹Pub. L. No.112-239 § 832. For purposes of this report, except in those situations where we are quoting the NDAA for Fiscal Year 2013, we use the term company when referring to contractors.

internal audits and examined a random, nongeneralizable sample of eight DCAA requests for companies' internal audits to determine if the records contained a written request for the company audit reports, a link between the work DCAA was doing and the content of the company reports, and a record of the company's response. We based our evaluation of DCAA's documentation on standards for evidence and supervisory review contained in generally accepted government auditing standards (GAGAS).

We also interviewed DCAA officials about implementation of the revised guidance and the process for compiling the documents. We concluded that the data contained in the requests submitted by the regions were sufficiently reliable for the purpose of selecting a sample. The results of our examination provide insights into how the regions are implementing the guidance but cannot be generalized across DCAA's requests for internal audits.

To determine how DCAA proposed to safeguard company internal audit reports, we examined DCAA's revised guidance and memorandums implementing the guidance. We discussed DCAA's future plans to safeguard company audits with DCAA officials and discussed company perspectives on safeguards with an organization consisting of company financial executives. Appendix I has additional information on our scope and methodology.

We conducted this performance audit from April 2014 to November 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Both DCAA and company internal auditors have responsibility for assessing the quality of company internal controls. Broadly speaking, internal controls refer to management processes designed to provide reasonable assurance about a company's ability to provide reliable financial reporting, promote effective and efficient operations, and comply with applicable laws, regulations, and contract provisions. As part of their overall governance, many companies establish internal audit departments to monitor adherence to management policies and controls, report exceptions to policies and procedures, and track corrective actions.

In addition to a company's own internal audit department, companies that provide goods and services to the Department of Defense may be audited by DCAA. As required by the Federal Acquisition Regulation, DCAA's audits examine incurred costs and business systems used in the execution of government contracts. As a part of its audits, DCAA examines internal controls for those systems. DCAA's contract audit services are intended to help ensure that prices paid by the government are fair and reasonable and that companies are charging the government in accordance with applicable laws, regulations, cost accounting standards, and contract terms. At the completion of an audit, DCAA provides the contracting officer with a report to assist in negotiations or in assessing contract costs, as well as in determining compliance with regulations and contractual requirements.

DCAA, which employs over 4,000 auditors, consists of a headquarters office at Ft. Belvoir, Virginia and six major organizational components—five regional offices across the United States that direct and administer audits for assigned geographical areas and a field detachment office that audits classified contracting activity. The six components manage over 300 field audit offices that conduct DCAA's work. Field audit offices can be categorized as branch offices, resident offices, or suboffices.

- Branch offices are located within each region and have responsibility for all contract audit services within the assigned geographical area.
- Resident offices are established at company locations where the audit workload justifies assignment of a permanent staff of auditors.
- Suboffices are established by regional directors as extensions of branch or resident offices when required to furnish audit services. A suboffice depends on its parent field office for release of reports.

For larger companies with operations at multiple locations, DCAA assigns a Contract Audit Coordinator who serves as a central point of communication between DCAA auditors and company representatives.

DCAA audits are governed by GAGAS. These standards require evaluation and testing of a company's overall internal controls including the work of the company's internal audit activity, specific controls, and business systems. They also require adherence to the standards when documenting and reviewing audit work.

DCAA's procedures for adhering to GAGAS in conducting different types of audits, such as audits of internal controls or company business

systems, are contained in its Contract Audit Manual. According to the audit manual, auditors should consider the company's self governance programs when assessing the adequacy of the internal controls to determine the scope of a DCAA audit. Further, the audit manual states that audits of individual business systems are to include an evaluation of the internal control activities applicable to that system.

GAO's Prior Work on Contractor Internal Control Reports and DCAA's Access

In a December 2011 report, we examined DCAA's process for discovering, requesting, and tracking selected companies' internal audit reports. We found that the process varied among the different DCAA offices, DCAA requested few audit reports, and DCAA did not track the disposition of requests for the reports.² Our work showed that DCAA did not always obtain these reports, either because the companies declined to provide them or because DCAA did not request them. Further, DCAA did not track company responses to its requests. We recommended that DCAA establish central points of contact for each company, periodically assess information compiled by the central points of contact, and reaffirm with staff through revisions to the guidance and additional training under what circumstances company internal audit reports could be requested and used. DCAA generally concurred with our recommendations and in August 2012 revised the Contract Audit Manual to implement the recommendations, issued memorandums for Regional Directors, and stated that they planned to provide additional training.

Recent Legislation

Subsequent to our 2011 report, section 832 of the NDAA for Fiscal Year 2013 required DCAA to revise its guidance on access to defense contractor internal audit reports.³ The act also required DCAA to appropriately document requests for internal audit reports. The required documentation should include, at a minimum, the following documentation:

- Written determination that access to contractor internal audit reports is necessary to complete required evaluations of contractor business systems;

²GAO, *Defense Contract Audits: Actions Needed to Improve DCAA's Access to and Use of Defense Company Internal Audit Reports*, GAO-12-88 (Washington, D.C.: Dec. 8, 2011).

³Pub.L 112-239 § 832 (a).

-
- A copy of any request from DCAA to a contractor for access to the internal audit reports; and
 - A record of the contractor's response to include a reason or justification if access to the requested internal reports was not granted.

In addition, the NDAA required that DCAA revise its guidance to include safeguards and protections to ensure that the internal audit reports could not be used for any purpose other than evaluating and testing the efficacy of contractor internal audit controls and the reliability of associated contractor business systems. The act also provided that contractor internal audit reports could provide a partial basis for determining that the contractor has a sound system of internal controls, which, in turn, could provide a basis for reduced testing by DCAA.

DCAA Revised Its Policies but Additional Attention Needed For Implementation

DCAA revised policies and guidance to incorporate documentation requirements for requests for companies' internal audit reports as mandated in section 832 of the NDAA. In particular, its revised guidance establishes a process to track auditor's requests and company responses for internal audits and requires its regional offices to submit a semi-annual summary of all requests for internal audit reports to be sent to headquarters in June and December of each year. However, the information contained in all eight requests we reviewed, which had been submitted for the December 2013 semi-annual report, included only partial documentation, and there were inconsistencies in the timing for the submission of information for the report.

DCAA Revised Its Guidance as Required by the NDAA for Fiscal Year 2013

DCAA revised the Contract Audit Manual in April 2013 to include directions for auditors to document requests for company internal audits as required in the NDAA for Fiscal Year 2013. The revisions state that auditors should include documentation to show:

- how the company's internal audit is related to the work DCAA is conducting—that is, a written explanation of how access to such reports is necessary to complete required evaluations of contractor business systems;
- a copy of any request from DCAA to a company for access to such reports; and

-
- a record of response received from the contractor, including the contractor's rationale or justification if access to requested reports was not granted.

In addition to the NDAA requirements, DCAA's guidance requires that auditors follow up on denials for the reports and initiate denial of access paperwork to inform DCAA management about such denials. DCAA disseminated the guidance through a Memorandum for Regional Directors in April 2013, and included a template for collecting information for tracking and monitoring the access. Further, DCAA provided training for audit staff to explain the new guidance and reporting requirements.

Required Documentation Is Incomplete for Selected Cases

None of the eight requests for company internal audit reports we selected in a random, nongeneralizable sample contained all documentation required by the NDAA provisions and DCAA's guidance. All eight records contained documentation of DCAA's request to the company, but none contained a full statement of the requested report's connection to DCAA's work and two did not cite any connection. As an example, the determination recorded in one working paper was the following: "We determined that we should view [the audit report] to support our assessment of the efficacy of internal controls." While the justification states that the internal audit report would support DCAA's assessment of internal controls, it does not identify which aspects of internal controls were to be particularly addressed. That is, it does not provide a detailed explanation of how the internal report was connected to the ongoing work of evaluating internal controls or risk assessment.

In terms of documenting the companies' response, one request did not provide any record of the company's response. Of the seven requests that contained some documentation of the company's response, the documentation recorded ranged from providing a copy of the contractor's response to recording only a date. We note that DCAA auditors could have additional information, such as an email from the company, which would provide stronger evidence of the company's response. The documentation for three requests contained a notation of the kind of access provided and a date. DCAA officials stated that recording a date and the type of access granted, if a copy of the report was not provided met their interpretation for providing a record of the response, and we assessed them as documented. The request that contained only a date we assessed as not documented.

Figure 1 provides information about the extent to which the eight regional submissions contained the required documentation.

Figure 1: Documentation for Eight Randomly Selected DCAA Requests to Companies for Internal Audit Reports

Internal audit	Recorded connection to DCAA audit	National Defense Authorization Act required documents		
		Request to company for internal report	Company's response included	
A	●	✓	✓	✓
B	●	✓	✓	✓
C	●	✓	✓	✓
D	●	✓		○
E	●	✓	✓	✓
F	○	✓	✓	✓
G	○	✓		○
H	●	✓	✓	✓

✓ Documented
 ● Partially documented
 ○ Not documented

Source: GAO analysis of DCAA data. | GAO-15-44

Four of the requests we reviewed were, at first, denied by the companies; three of the denied requests contained the company's response detailing the company's rationale for the denial, and one did not have any documentation of the company's response. The documentation requirements were not applied consistently for the cases we reviewed, and without consistent application of the documentation requirements, the reason for asking for the audit and the connection to DCAA's work is unclear. In cases where the companies denied the requests, documentation is essential for determining the reason for the denial and perhaps following up with a stronger connection between DCAA's work and the request to the company.

DCAA auditors we spoke with identified factors contributing to less than full documentation for the requests we reviewed. First, they said that the information they had on the internal audit reports was limited to only the title of the audit, and that while the title could provide some information, it might not contain enough information to provide a strong link between DCAA's work and the requested audit. Second, they stated that the instruction about documenting the connection between DCAA's work and

the requested audit or the benefit to DCAA was not clear. Third, an official stated that the contents of the documents were not reviewed for completeness. Finally, in the case of documentation of the company's response, some officials stated that they believed documentation, such as an email, was needed only if the request resulted in a denial of access.

Supervisory review of audit documentation is required by GAGAS.⁴ The incomplete documents including the complete lack of some documents could have been remedied if supervisory review by field offices and/or contract audit coordinators were undertaken. However, it is unclear to what extent the data provided by the auditors for the semi-annual reports are consistently reviewed by the field offices, contract audit coordinators, or headquarters. One regional official stated that records were reviewed in that region to assure the completeness of the report, but officials from another region indicated that records were only reviewed if the request for a contractor internal audit resulted in a denial of access. The guidance simply states that a connection between DCAA's work and the requested audit should be in the request. The guidance does not provide examples of how a connection should be stated. Examples of a well-developed connection in the guidance could improve the documentation.

Semi-Annual Report Could Provide Insight into Company Responsiveness and the Benefits of Access

DCAA's guidance states that auditors are to provide the information on their requests for company internal audits in a semi-annual report to Headquarters. The semi-annual report tracks the number of requests for internal audit reports and the disposition of those requests by the companies over a 6-month period. For consistency, the auditors use a template to compile the information.

The submissions used the template provided; however, we found inconsistencies in the regions' approaches to the submissions. According to DCAA officials, each region developed its own process for implementing the revised guidance. For example:

- DCAA's guidance requires each region to submit aggregated data for the report by June 1 and December 1. Since the guidance does not specify a cut-off date for field offices and Contract Audit Coordinators to submit reports to their respective region, each region established its own reporting deadlines. We found cut off dates ranging from October

⁴GAO, *Government Auditing Standards*, GAO-12-331G (Washington, D.C.: Dec. 2011).

15 to November 29 for the December 1, 2013, report. Since DCAA headquarters does not adjust the reporting periods for each region to consolidate the data, the report may not be a complete snapshot of the requests and the disposition of the requests for the reporting period. Also, the timing inconsistencies in data cut-off dates for the semi-annual reporting may make it more difficult to establish a starting date for subsequent reporting periods resulting in overlapping data—possibly double counting requests or not including some requests. The regional reports are aggregated to develop an agency wide report on requests for company internal audits and the lack of a consistent process limits DCAA's ability to compile complete data or know about the extent to which they have obtained access to contractor internal reports in a given period.

- The guidance states that auditors track requests to major contractors. However, the number of major contractors varies from reporting period to reporting period. Some factors influencing the variation include the following:
 - to be classified as a major contractor, companies must have \$100 million or more in reimbursable claims in the company's fiscal year. Some companies do not meet that threshold every year.
 - DCAA officials told us that they may not have ongoing work at the right stage for requesting internal audits, so a company may not be included in a list of major contractors for a given period.

DCAA officials explained that field offices should include major contractors in the semi-annual report if the contractor has an internal audit department, and there is an ongoing DCAA audit. They explained that the agency's internal database can be used to identify major contractors. However, we could not find a consistent process employed by regional offices to verify that all major contractors where DCAA had ongoing work are being tracked in the reports. While one regional official stated that the person responsible for the regional report obtained a list of major contractors and ensured that all were included in the report, an official from another region indicated that the person responsible relied on each field office to know which contractors fell under its jurisdiction and should be included in the report. Without identifying the universe of major contractors, DCAA may not be able to determine the percentage of companies from whom it is requesting, receiving, or not receiving reports. Such information would be useful in determining whether obtaining

companies' internal control audits is helpful to DCAA in assessing audit risk and in streamlining its audit work.

Guidance Revisions Define Physical Safeguards for Internal Audit Reports, but Not for Unauthorized Use

In accordance with section 832 of the NDAA for Fiscal Year 2013, DCAA revised its contract audit guidance to include language on safeguarding companies' internal audit reports noting that the act states that the safeguards should prevent the agency from using the reports for purposes other than evaluating and testing (1) the efficacy of internal controls and (2) the reliability of business systems. DCAA's revised guidance addresses physical safeguards, but the guidance does not include a clear distinction between authorized and unauthorized use nor describe a specific process to safeguard companies' internal audit reports from such unauthorized use. However, DCAA has additional planning underway to develop electronic safeguards that they believe will address this issue.

Revised Guidance Includes a Discussion of Appropriate Safeguards

DCAA's Contract Audit Manual includes revised guidance that identifies appropriate physical safeguards for companies' internal audit reports. The revised guidance, for example, outlines physical safeguards such as identifying and protecting companies' proprietary information as well as assigning responsibility for safeguarding companies' information. In particular, one revision in DCAA's audit manual states that when proprietary information is located in a secure building, the information can be stored in unlocked containers, but if the information is located in an unsecured building, the information should be stored in locked containers. Additionally, DCAA's revised guidance tasks the agency's auditors with being responsible for protecting such information, including making sure that they do not release proprietary information outside of appropriate channels. A central point of contact is to be responsible for safeguarding copies of the internal audit, providing the report for use in other audits only when the need arises.

Revised Guidance Does Not Define Authorized Use or Prescribe Safeguards

Section 832 of the NDAA for Fiscal Year 2013 states that the guidance should include appropriate safeguards and protections to ensure that the internal audit reports are not used for purposes unrelated to evaluating and testing the efficacy of internal controls and the reliability of business systems. Although DCAA's revisions acknowledge responsibility to provide physical safeguards, the guidance does not provide examples of authorized use or describe or define unauthorized use.

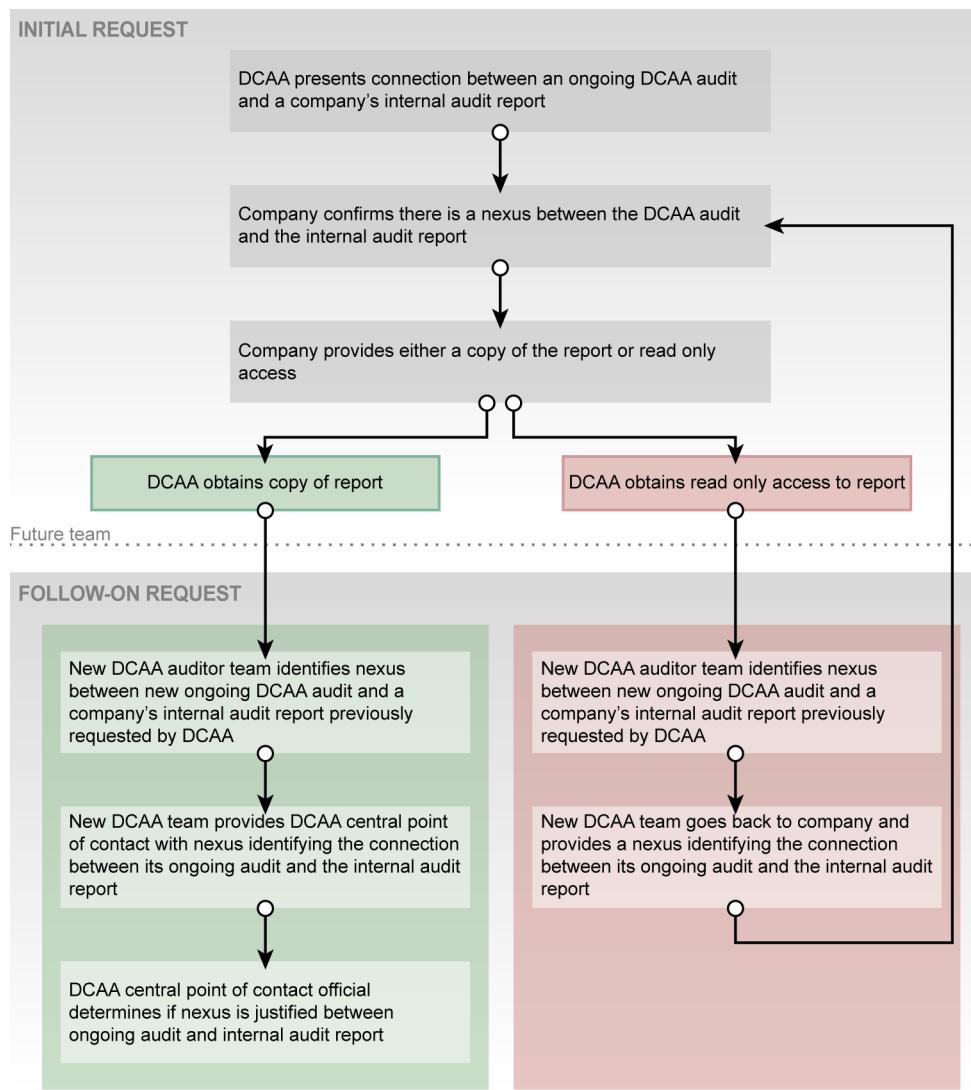
When we spoke with representatives of several companies about safeguards, they provided varying perspectives on authorized use.

According to some company representatives that we spoke to, “authorized use” is considered to be sharing an internal audit report among auditors assigned to the same company. Other representatives told us, however, that they define “authorized use” as limited to use within a specific DCAA audit team on a specific occasion, and such use does not extend to sharing the internal audit report with any other audit team. Company representatives also stated that they believed DCAA used internal audit reports as a means of identifying particular transactions to investigate further, a use they believe is not in accordance with the language of the NDAA. In their opinion, an authorized use is defined as examining the reports only to assign an appropriate level of risk to the business system under review. Without a specific definition of authorized use, DCAA may not have consistent criteria to determine if and when circumstances warrant sharing an audit report beyond the initial request.

DCAA Has Initiatives Underway on Sharing and Storing Internal Audit Reports

DCAA officials explained that the agency has two procedures for those cases where DCAA is able to obtain copies of companies’ internal audit reports or takes such extensive notes that the report is virtually copied—one manual and an electronic process in development. First, DCAA officials said that the agency has a general process for evaluating whether new DCAA audit teams’ requests for previously obtained reports are justified. Specifically, the officials told us that DCAA has identified a central point of contact within each of its six components to maintain custody of, and monitor access to, internal audit reports and will also have a backup in case the designated contact is unavailable. The officials explained that after the DCAA central point of contact takes custody of a copy of a company’s internal audit report, any new DCAA team that identifies a need for that report will need to present an assessment demonstrating the need for the company’s internal audit for its ongoing audit to the DCAA central point of contact. If the central point of contact decides that the new DCAA team has established a sufficient case for examining the audit report, the contact will grant access to that audit team. DCAA officials told us that if the central point of contact grants access, DCAA would not necessarily provide the company with any type of notification. Figure 2 provides a decision matrix showing the process for providing the audit, based on whether or not the company provides a copy to DCAA.

Figure 2: Process for Controlling Use of Internal Audit Reports



Source: GAO analysis. | GAO-15-44

Second, DCAA officials also said they are exploring an electronic storage system to maintain copies of companies' internal audit reports and related documentation, if provided. According to DCAA officials, the central point of contact will use the electronic storage system as a method to safeguard the internal audit reports by limiting auditors' access rights on a need-to-know basis. DCAA officials told us that, based on their outreach

to a small group of company representatives, they expect companies will react positively to the electronic storage system. One benefit provided by the electronic system, according to DCAA officials, is that the system is expected to increase DCAA's ability to obtain copies of companies' internal audit reports because of the increased safeguards.

However, company representatives we met with told us that they have concerns with providing copies of internal audit reports and ceding the decisions about when DCAA can use them. The representatives said that with this shift in granting authorization to use the reports, they are concerned that DCAA can share the proprietary reports without their specific consent, possibly leading to unauthorized use. Further, the representatives told us that such unrestricted sharing would not allow the company to see the context in which the internal audits are being used. They also stated that they have concerns about any electronic storage system being targeted by cyber attacks in order to gain access to proprietary information. DCAA officials stated they would take these concerns into account as they develop the system.

Conclusions

DCAA has revised the Contract Audit Manual to require documentation of information as specified by section 832 of the NDAA for Fiscal Year 2013 regarding requests for contractors' internal audit reports. However, the revisions to the Contract Audit Manual alone are not sufficient to assure that sharing companies' internal audit reports is necessary to DCAA's work and that DCAA will use the reports only in order to evaluate business systems or to assess risk associated with a particular audit. In order to be convincing, the requests for internal audits should include a specific discussion of DCAA's need for the internal audit and how it is connected to DCAA's work. As described in the NDAA, the internal audit reports can be used to provide a basis for streamlining DCAA's work. However, the requests for the internal audits we examined contained only partial information about the connection of the company's internal audit to DCAA's work and little, if any, discussion of benefits such as reduction in risk level or potential reduction to testing based on a consideration of the work of company internal auditors. Enhanced internal controls, such as supervisory review of the required documentation, could assist in assuring that the required information is provided for each request.

Although the revisions to the guidance echo the language in the NDAA, they do not provide a definition of authorized use. Demonstrating that DCAA has clearly defined and understands the elements of authorized use is critical to reassure companies that their internal audits will be used as a benefit to both the companies and to DCAA. If DCAA does not

rigorously implement its revisions, some companies may be reluctant to provide DCAA with access to their internal audit reports. And, without the information from these reports, DCAA may have limited insight into companies' internal controls over its business systems and may miss opportunities to inform and streamline its audit plans.

Recommendations for Executive Action

To help improve the process for requesting company internal audit reports, we recommend the Secretary of Defense direct the Director, DCAA, to take the following two actions:

1. clarify the guidance in the Contract Audit Manual to
 - further define, with examples, the specific details that should be in the requests for company internal audits including how such internal audits are specifically tied to DCAA's work and
 - provide a definition of authorized use and examples of such use; and
2. establish and monitor internal controls for a reporting cut-off date, identifying major contractors, and ensuring information has been reviewed for completeness and accuracy.

Agency Comments and Our Evaluation

We provided a draft of this report to the Department of Defense for review and comment. In its written comments, which are reprinted in appendix II, the department concurred with our recommendations and described the actions it plans to take by March 31, 2015. For our recommendation to further revise its guidance to define, with examples, the specific details that should be in the requests for internal audits and to provide a definition of authorized use and examples of such use, the department noted DCAA had provided training and guidance, but also noted that a more detailed definition in the Contract Audit Manual and specific examples, in a guidebook or as best practices, were necessary. For our recommendation to establish and monitor internal controls for a reporting cut-off date, identifying major contractors, and ensuring information was reviewed for completeness and accuracy, the department stated that DCAA would update the audit manual to specify the cut-off date and establish a process for ensuring that all the major contractors that should be included are, in fact, included. Further, DCAA agreed to update the audit manual to include procedures for ensuring documentation is complete for each request.

DCAA provided technical comments, which we incorporated in the report where appropriate.

We are sending copies of this report to the appropriate congressional committees, the Secretary of Defense and the Director, Defense Contract Audit Agency, and other interested parties. In addition, the report is available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-4841 or woodsw@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix III.

A handwritten signature in black ink that reads "William T. Woods".

William T. Woods
Director
Acquisition and Sourcing Management

List of Committees

The Honorable Carl Levin
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The Honorable James M. Inhofe
Ranking Member
Committee on Armed Services
United States Senate

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The Honorable Adam Smith
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Committee on Armed Services
House of Representatives

The Honorable Rodney Frelinghuysen
Chairman
The Honorable Pete Visclosky
Ranking Member
Subcommittee on Defense
Committee on Appropriations
House of Representatives

Appendix I: Scope and Methodology

Section 832 of the National Defense Authorization Act (NDAA) for Fiscal Year 2013 required that the Comptroller General review the documentation applicable to the act's requirement that the Defense Contract Audit Agency (DCAA) revise its audit guidance to include directions for appropriate documentation of its requests to contractors for their internal audit reports.¹ The revised guidance was also to include guidance for implementing appropriate safeguards for company internal audits. We assessed (1) the extent to which DCAA's revised guidance complied with the act and whether selected requests for company internal audit reports were documented in accordance with the requirements, and (2) the extent to which DCAA's revised guidance contains safeguards to help ensure that internal audit reports obtained from companies are used only for authorized purposes.

To address our objectives, we compared the provisions of the act to the revised audit guidance to determine whether the revisions included directions for documenting requests for company internal audits, the connections to DCAA's work and the company's responses and safeguards for the internal audits. We obtained DCAA submissions to headquarters for 163 requests with embedded documents. The documents included the requests, any response from the company, and the written connection between the requested audit and DCAA's ongoing work. We interviewed officials about the process for compiling the documents and examined DCAA's implementing guidance. We concluded that the data were sufficiently reliable for the purpose of selecting a sample and determining whether the requests contained the required information in accordance with our objectives. We selected a nongeneralizable, random sample of 8 DCAA requests from the 163 requests DCAA sent to companies between June 1, 2013, and December 1, 2013, to examine in detail. We compared the documents provided with each request to both the NDAA requirements and DCAA's guidance to determine if the records contained (1) a written request for the company audit reports, (2) a link between the work DCAA was doing and the company report requested and (3) the company response. We interviewed DCAA officials about changes to the Contract Audit Manual, memorandums amplifying the requirements in the NDAA, training provided to auditors, and any management reviews to ensure the guidance was executed according to DCAA policy. We based our

¹Pub. L. No. 112-239 § 832.

evaluation of DCAA's documentation on standards for documentation and supervisory review contained in generally accepted government auditing standards (GAGAS).

We believe the information we collected was sufficiently reliable to provide a reasonable basis for our analysis.

To evaluate the extent to which DCAA officials are monitoring the execution of the guidance, we obtained management reports for two of the semi-annual periods, January to June, 2013, and June to December, 2013. We compared the guidance in the templates provided for reporting information about company requests with the information contained in the spreadsheets prepared for the reports. Our analysis included checking that the request to the company was included in the documentation; that the request contained a clear connection between DCAA's work and the audit and that it included how obtaining the audit would benefit DCAA's work; we examined the documentation for evidence of a company response and for the rationale for denying the request, if a request was denied by the company. We determined that the electronic documentation was reliable for the information we sought. We contacted DCAA auditors in cases where documentation appeared lacking to determine their understanding of the documentation required. The results of our examination provide insights into how the regions implement the guidance but cannot be generalized across DCAA's requests for internal audits.

To determine DCAA response to providing safeguards for company internal audit reports, we compared DCAA's revised guidance to the NDAA for Fiscal Year 2013 requirements. We obtained memorandums implementing the guidance and compared it to the guidance in the Contract Audit Manual. We discussed DCAA's response to the NDAA requirements for safeguarding company audits with DCAA officials. We also discussed DCAA's plans to take additional steps to safeguard company audits and discussed the timing of those plans. To obtain the perspective of companies who have been asked or may be asked to provide internal audit reports, we met with representatives of the Committee on Government Business of Financial Executives International organization and discussed company perspectives on safeguards and the definition of authorized use.

We conducted this performance audit from April 2014 to November 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain

sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Comments from the Department of Defense

 DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
8725 JOHN J. KINGMAN ROAD, SUITE 2135
FORT BELVOIR, VA 22060-6219

OFFICE OF THE DIRECTOR

November 3, 2014

Mr. William T. Woods
Director, Acquisition and Sourcing Management
U.S. Government Accountability Office
441 G Street NW, Washington DC 20548

Dear Mr. Woods:

This is the Department of Defense (DoD) response to the GAO Draft Report, GAO-15-44, DEFENSE CONTRACT AUDIT AGENCY: Additional Guidance Needed Regarding DCAA's Use of Companies' Internal Audit Reports, dated October 3, 2014 (GAO Code 121182).

Thank you for the opportunity to respond to the subject draft report. Our response to the draft report recommendations are shown below:

RECOMMENDATION 1: The GAO recommends that the Secretary of Defense direct the Director, DCAA, to clarify the guidance in the Contract Audit Manual to:

- Further define, with examples, the specific details that should be in the requests for internal audits including how such internal audits are specifically tied to DCAA's work, and
- Provide a definition of authorized use and examples of such use.

DoD RESPONSE: Concur.

DCAA guidance and training pertaining to accessing internal audits discussed the need for providing a nexus to an ongoing audit when requesting access to internal audits. However, based on the findings in this report, it is clear that a more detailed definition, including examples with the specific details that should be in the requests, is necessary to ensure the field auditors are clear on what information should be in the request. Additionally, DCAA designated points of contact at each FAO are responsible for safeguarding the contractor's internal audit reports, and for determining whether future auditors should gain access to an internal audit report, based on a nexus to their ongoing audit. However, DCAA did not specifically define authorized and unauthorized use, or give specific examples of such use.

DCAA will review the Contract Audit Manual guidance and provide definitions that are more detailed. Additionally, DCAA will provide examples, either in a guidebook or as a best practice, to assist auditors in writing requests for internal audits that contain well-developed connections between the internal audit report and the ongoing audit, and to assist them in determining what is considered authorized use. DCAA will complete these actions by March 31, 2015.

RECOMMENDATION 2: The GAO recommends that the Secretary of Defense direct the Director, DCAA, to establish and monitor internal controls for a reporting cut-off date, identifying major contractors, and ensuring information has been reviewed for completeness and accuracy.

DoD RESPONSE: Concur.

DCAA agrees that the guidance is not clear on the reporting cut-off date. The guidance states that the data must be submitted to Headquarters semiannually by June 1 and December 1, but the date for cutting off the data for submission is not clear, and appears to be inconsistent across the Regions. DCAA will update the Contract Audit Manual guidance to include specific cut off dates to ensure the consolidated data is consistent and complete.

DCAA also agrees that a consistent process should be established for ensuring the report is complete with all relevant major contractors included. DCAA currently has no formal procedures in the guidance to ensure steps are taken to determine if the report is complete (includes all of the major contractors it should). DCAA will update the guidance to include procedures for ensuring all relevant major contractors are included in the report, and will provide the field a tool to use to ensure these procedures are documented and consistent across the Agency.

DCAA also agrees that there are no formal procedures for ensuring that the documentation requirements are reviewed for completeness and accuracy. In addition to the actions above to provide examples to assist auditors in writing requests for internal audits that contain well-developed connections between the internal audit report and the ongoing audit, DCAA will also update the guidance to include procedures for ensuring all required documentation exists for each item reported.

DCAA will complete all actions in response to this recommendation by March 31, 2015.

Questions regarding this letter should be directed to Mr. Joe Garcia, Executive Officer, at (703) 767-3265 or e-mail joe.garcia@dcaa.mil.



Anita F. Bales
Director

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

William T. Woods, (202) 512-4841 or woodsw@gao.gov

Staff Acknowledgments

In addition to the contact named above, Penny Berrier, Assistant Director, Marycella Cortes, Jessica Drucker, Danielle Greene, John Krump, Jean McSween, Carol T. Mebane, and Ozzy Trevino made key contributions to this report.

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